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## Further Guidance on Where Real Property Interests Constitute an Interest in a Closely- Held Business for Purposes of I.R.C. § 6166

-by Neil E. Harl\*

The rules for “15-year”<sup>1</sup> installment payment of federal estate tax<sup>2</sup> require that the value of an “interest in a closely held business” exceeds 35 percent of the adjusted gross estate.<sup>3</sup> The statute specifies that an interest in a closely held business means an interest as a proprietor in a trade or business carried on by a proprietorship, an interest as a partner in a partnership carrying on a trade or business or stock in a corporation carrying on a trade or business.<sup>4</sup> However, there is no statutory guidance on the circumstances in which ownership of real property is deemed to be a trade or business. This has long been a matter of concern in farm and ranch estate (and business) planning because of the almost dominant role played by real estate in farm and ranch operations.

Recently, the Internal Revenue Service provided additional guidance, including a nonexclusive list of factors, to be used in determining whether a decedent’s interest in real property is an interest in an active trade or business so as to constitute an interest in a closely held business for purposes of installment payment of federal estate tax.<sup>5</sup>

### Revenue Rulings issued in 1975

In 1975, the Internal Revenue Service issued three revenue rulings in an attempt to provide guidance on the circumstances in which real estate would meet the “trade or business” requirement.<sup>6</sup> Two of the rulings, Rev. Rul. 75-366<sup>7</sup> and Rev. Rul. 75-367<sup>8</sup> provided guidance primarily on commercial and residential real property. The other ruling, Rev. Rul. 1975-366<sup>9</sup> focused on farm real estate.

The recently issued guidance, Rev. Rul. 2006-34,<sup>10</sup> revoked Rev. Rul. 1975-365<sup>11</sup> and revoked a portion of Rev. Rul. 1975-367.<sup>12</sup> The 2006 ruling did not disturb the farm ruling, Rev. Rul. 1975-366<sup>13</sup> which involved a share rent lease in which the decedent, the landlord, paid 40 percent of the expenses, received 40 percent of the crops and actively participated in the important management decisions of the farming operation. That ruling, along with subsequent rulings<sup>14</sup> and cases<sup>15</sup> made it clear that cash-rented farm real estate is unlikely to be considered an interest in a trade or business. A 2005 ruling, with non-farm facts, acknowledged that cash rental prior to death precludes eligibility for installment payment of federal estate tax, even as to paying deficiencies, unless the land is used as an integral

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part of a trade or business in which the decedent was involved.<sup>16</sup>

Over the years, rulings resolved two other issues not made clear in Rev. Rul. 1975-366<sup>17</sup>— (1) whether only the decedent could provide the necessary management to meet the trade or business test<sup>18</sup> and (2) whether material participation was required for eligibility to be established.<sup>19</sup>

### The 2006 ruling

Rev. Rul. 2006-34,<sup>20</sup> states that, to be an interest in a trade or business under I.R.C. § 6166, a decedent must conduct an active trade or business or must hold an interest in a partnership, LLC or corporation that itself carries on an active trade or business.<sup>21</sup> The 2006 ruling goes on to state that, to determine whether a decedent's interest in real property is an interest in an active trade or business, IRS will consider the following non-exclusive factors – (1) the amount of time the decedent (or agents or employees, the decedent's partnership, LLC or corporation) devoted to the trade or business; (2) whether an office was maintained from which the activities were conducted or coordinated and whether regular office hours were maintained; (3) the extent to which the decedent (or employees or agents of the decedent, partnership, LLC or corporation) were actively involved in finding new tenants and negotiating and executing leases; (4) the extent to which the decedent (or employees and agents) provided landscaping, grounds care or other services beyond the furnishing of the leased premises; (5) the extent to which the decedent (or employees and agents) personally made, arranged for or supervised repairs and maintenance of the property and (6) the extent to which the decedent (or employees and agents) handled tenant repair requests and complaints.<sup>22</sup>

The 2006 ruling also states that the fact that some of the activities are conducted by third parties such as independent contractors who are neither agents nor employees of the decedent, partnership, LLC or corporation will not prevent the business from qualifying as an active trade or business so long as the third party activities are not of such a nature that the activities are reduced to the level of merely holding investment property.

The fact that the 2006 ruling did not disturb the 1975 farm and ranch guidance<sup>23</sup> and the fact that the five examples in the 2006 ruling all involve non-farm fact situations indicate that the guidance for farm and ranch estates will continue to come, predominantly, from the 1975 farm ruling and the other guidance that has emerged since 1975.

### Footnotes

<sup>1</sup> In reality, the installment payment period is 177 months after death which is three months short of 15-years. See 5 Harl *Agricultural Law* § 42.05 (2006).

<sup>2</sup> I.R.C. § 6166.

<sup>3</sup> I.R.C. § 6166(a)(1). See generally 5 Harl *Agricultural Law* § 42.05 (2006); Harl, *Agricultural Law Manual* § 5.05[1] (2006).

<sup>4</sup> I.R.C. § 6166(b)(1).

<sup>5</sup> Rev. Rul. 2006-34, 2006-1 C.B. 1171.

<sup>6</sup> Rev. Rul. 75-365, 1975-2 C.B. 471; Rev. Rul. 75-366, 1975-2 C.B. 472; Rev. Rul. 75-367, 1975-2 C.B. 472.

<sup>7</sup> 1975-2 C.B. 471.

<sup>8</sup> 1975-2 C.B. 472.

<sup>9</sup> 1975-2 C.B. 472.

<sup>10</sup> 2006-1 C.B. 1171.

<sup>11</sup> 1975-2 C.B. 471.

<sup>12</sup> 1975-2 C.B. 472.

<sup>13</sup> 1975-2 C.B. 472.

<sup>14</sup> Ltr. Rul. 8515010, Jan. 8, 1985 (cash rent lease of pasture and barn did not qualify as interest in closely-held business where decedent provided only routine maintenance of property); Ltr. Rul. 9403004, Oct. 8, 1993 (decedent received “fixed rental” for leasing land; not engaged in trade or business).

<sup>15</sup> *Smith v. Booth*, 86-2 U.S. Tax Cas. ¶ 13,686 (W.D. Tex. 1986), *rev'd and rem'd*, 823 F.2d 94 (5th Cir. 1987) (cash rent lease to unrelated tenants; reversed on appeal because of sovereign immunity since case did not involve suit for refund).

<sup>16</sup> Ltr. Rul. 200518011, Jan. 14, 2005 (involved land cash rented to corporations carrying on automobile dealerships; met trade or business test). See *Heffley v. Comm'r*, 884 F.2d 279 (7th Cir. 1989). See Harl, “Cash Renting Land: Eligibility for 15-Year Installment Payment, the Family-Owned Business Deduction and Special Use Valuation,” 16 *Agric. L. Dig.* 105 (2005).

<sup>17</sup> 1975-2 C.B. 472.

<sup>18</sup> A series of rulings held that the management activities of an employee or agent are imputed to the property owner in this instance. E.g., Ltr. Rul. 8133015, April 29, 1981 (decedent incapacitated; farms managed by spouse under crop share lease met trade or business test).

<sup>19</sup> Ltr. Rul. 8432007, April 9, 1984 (payment of self-employment tax not required to meet trade or business test).

<sup>20</sup> 2006-1 C.B. 1171.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> Rev. Rul. 1975-366, 1975-2 C.B. 472.